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SUBJECT: GEORGIA: SCENESETTER FOR EWG AND VISIT OF EEB A/S
FERNANDEZ

Classified By: Ambassador John R. Bass for reasons 1.5 (b) and (d).

11. (C) SUMMARY: Once infamous for its rampant corruption and organized crime, Georgia is now a model of reform among post-Soviet economies. The economy and Georgia's pro-business orientation are top priorities for President Saakashvili and he is quick to highlight his government's successes. Managing a weakened economy that is starting to rebound from the August 2008 conflict with Russia and the world economic crisis remains the biggest domestic challenge for the Government. However, as the Government focuses on finding new sources of financing and investment, it risks backsliding on the very reforms that define its success. Because the Saakashvili government in office only until 2013, there is a feeling that time is short and reform must happen now; if it is delayed, the opportunity might pass. As the prime initiator of economic reform, the Government is pushing ahead at all costs, and even public comment on laws sometimes remains a luxury policymakers believe they can not afford. Your visit and the Economic Working Group provide opportunities to encourage the government to stay the path of reform, but to also bring others into the process. Despite recent missteps, Georgia values its international reputation and listens carefully to its international partners and the business community. The Economic Working Group is a great venue to deliver a straightforward message: without implementation of promised reforms, increased transparency and greater predictability, and further development of rule of law, Georgia will struggle to attract legitimate, serious western investors. END SUMMARY.

CHALLENGES) WAR, FINANCIAL CRISIS

12. (C) After several years of double digit GDP growth and deepening economic reforms following the 2003 Rose Revolution, 2008 and 2009 were difficult, both politically and economically, for Georgia. In addition to the loss of 20% of Georgia's territory, the Georgian economy was hit hard during the August 2008 war with Russia. Russian troops controlled the country's major port and cross-country highway, stopping commerce into the region. More than 30,000 new internally displaced persons (IDPs) added to the stress on the Georgian budget, as the government struggled to quickly house these people before winter. Although most foreign investors stayed in place, inflows of new foreign direct investment slowed to a trickle as plans for new investments were put on hold or shelved. A few months later, the global financial crisis caused an even greater shock to the economy, with unemployment increasing sharply and investment and government revenues dropping precipitously. While pledges of assistance helped mitigate the worst of the financial crisis, led by the U.S. with our pledge of \$1 billion in post-conflict aid, the economy shrunk four percent in 2009. The Georgian Government was further challenged by domestic protests from April to July 2009 that negatively affected tax collection and discouraged investors. GDP is projected to grow by two percent in 2010, assuming continued global economic growth and the return of international

investments.

A CALMER GEORGIA, BUT INSECURITY RULES

¶3. (S) While today Georgia is calmer and more stable, these improvements are far from durable and a palpable sense of insecurity permeates society and politics. Miscalculations and provocations - domestically, in the territories or north Qand provocations - domestically, in the territories or north across the mountains - could easily spark renewed crisis. With a stabilized economy and no viable rival, President Saakashvili is stronger politically but paradoxically more insecure, burdened by the fear history will judge him to have lost irrevocably the occupied territories and concerned that our measured approach to defense cooperation and engagement with Moscow presage a deeper reorientation of U.S. interests.

These concerns are reinforced by a steady drumbeat of Russian accusations about the legitimacy and behavior of his government and comparative silence from the West about Moscow's consolidation of its position in the territories. In this hothouse environment, your visit is an important, visible manifestation of our commitment to support Georgia's reform and Euro-Atlantic aspirations - and an opportunity to remind the government that realization of those aspirations ultimately depends on a renewed commitment to deeper democratic and economic reforms. Saakashvili continues to cast about for the "one big thing" that will secure Georgia's place in the west. Our challenge is to convince President Saakashvili that the "one big thing" is a renewed commitment to Georgia's democratic and economic development, even while we work to prevent a slide back into conflict and instability.

GEORGIA) A MODEL FOR ECONOMIC REFORM

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¶4. (C) Although often overshadowed by political crisis and conflict over the separatist territories, reform and modernization of the Georgian economy has been one of the most tangible successes of the Rose Revolution. When it came to power in early 2004, the Saakashvili government inherited a barely functioning economy rampant with corruption and controlled by organized crime. The government quickly took steps, including a complete overhaul of the police and an aggressive no-tolerance policy for organized crime, to legitimize the economy. This led to increased jobs, increased tax collection and increased government revenue, fueled by large inflows of foreign direct investment and an aggressive privatization program.

¶5. (SBU) The Saakashvili government inherited a broken energy sector, where even in the capital electricity and gas were often unavailable. The government worked hard to diversify energy supplies and decrease its dependence on Russia. Georgia now has long-term energy agreements with Azerbaijan to provide natural gas. Thanks to a renewed government focus on developing Georgia's plethora of hydropower resources, the country is now a net exporter of electricity, selling kilowatts to Russia, Turkey and the larger Caucasus region. Planned infrastructure projects funded by the United States as well as other international donors and financial institutions will further strengthen Georgia's energy infrastructure, allowing for greater energy security and increased exports to energy starved markets in Eastern Turkey.

RUSSIAN EMBARGO HAMPERS THEN STRENGTHENS ECONOMY

¶6. (C) An additional roadblock was thrown into Georgia's path towards economic development in 2006, when Russia) its largest trading partner) put into place a complete embargo on all Georgian goods. Georgian companies struggled to find new markets for Georgian goods, including its famous wine. Although Russia still prohibits the import of Georgian products, the Georgian economy has more than rebounded. It has diversified with new markets throughout the former Soviet

Union and Europe, and has increased the overall quality of its goods to better compete. Georgia is a member of the WTO and is currently discussing a free trade agreement with the European Union. Georgia benefits from the U.S. General System of Preferences program and is keen to discuss the possibility of free trade with the United States. We are in the process of discussing a new Bilateral Investment Treaty with Georgia to help promote further U.S. investments.

CHALLENGES REMAIN) TRANSPARENCY, PREDICTABILITY

17. (C) In spite of the global financial crisis, Georgia's economy is stronger and more resilient than it was five years ago. Many business people you will meet during your visit will highlight the importance of Georgia's reforms and the improvements to the business climate during the past five years. They will point out that Georgia is now 11th on the World Bank's "Ease of Doing Business Report," and was recognized internationally in 2009 for its sustained performance in reforming the laws and regulations that determine the business enabling environment. In fact, the GoG deserves great credit for simplifying the process of opening a business, and has streamlined taxes and engaged the business community in a constructive dialogue. It has fought against low-level corruption and won. The government has successfully harvested the low-hanging fruit of reform and reaped the benefits.

IMPLEMENTATION AND PERCEPTION

18. (C) Now, Georgia must tackle the harder issues - including transparency, predictability, and rule of law. As Georgia's share of the economic pie has shrunk, there have been more accusations of higher-level corruption and an increase in government control of and intervention into the market. Businesses perceive the government to be weighted in favor of companies that are willing to bend the rules, and do not believe the Georgian legal system can protect them. While Georgia has quickly adopted legislation to improve the judicial system, it has been slower to implement these protections. Increased aggressiveness and lack of transparency in tax collections during the past six months worry the business community, as Georgia seems to be backing away from the reforms that brought it success. Your visit provides an ideal opportunity to stress to all that Georgia must hold strong on its path of economic reform if it is to succeed in transforming this formerly failed state. If Georgia wants the foreign investment it so desperately seeks, it must complete its reform of the legal system; it must also

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present and protect a transparent, level-playing field where businesses can compete. In business, perceptions are as important as reality. If serious western investors hear that they can not get a fair shake in Georgia, they will look to other more predictable markets. The competition for investment dollars is fiercer than ever, and Georgia has to show both the political will and the willingness to tackle the hard issues if it wants to win.

CONFLICT AND INSECURITY

19. (C) It is hard to overestimate the extent to which an intense climate of insecurity permeates Georgian society and political culture. Russian forces, located as close as 25 miles to Tbilisi, are building permanent bases and Georgians confront a steady drip of Russian statements alleging Georgian aggression or announcing the latest step in incorporating Abkhazia into Russia's economy. Moscow's statements suggesting that Georgia is planning provocations in the North Caucasus have raised fears among Georgian officials that Russia is looking for another pretext for armed conflict. Tbilisi, in turn, is overly focused on weapons acquisition as an antidote to its jitters. It fears our approach to defense cooperation (heavily focused on

developing the structures and processes to assess threats, develop appropriate responses and make informed decisions about use of force before moving to acquisition) is a trade-off to secure Russian cooperation on other issues, such as Iran.

¶10. (C) The immediate security environment has stabilized, with fewer incidents along the administrative boundaries with the separatist territories of Abkhazia and South Ossetia. Shootings and explosions still occur, but much less frequently; detentions are the major source of tension, especially around South Ossetia. Overall the Abkhaz de facto authorities have proven more interested in engaging with international partners. The South Ossetians are steadfastly uncooperative, even when proposals would benefit their own residents.

DOMESTIC POLITICAL CHALLENGES

¶11. (SBU) The Saakashvili-led United National Movement (UNM) continues to hold a constitutional majority in Parliament, and its current poll numbers reflect broad popular support. The government's restrained handling of the months-long opposition protests in 2009 reinforced Saakashvili's and his party's popularity throughout the country and reduced support for opposition leaders. The government has made tangible democratic progress, including the passage of a new electoral code in December, 2009, which will set rules for upcoming May 2010 municipal elections. The divergent positions and motives of the opposition precluded the kind of grand bargain which could have turned the electoral code into an engine for new democratic reforms. In the current zero-sum environment, the government did not stretch itself, either. The revised code has been sent to the Council of Europe's Venice Commission to assess its adherence to international standards. Substantial government influence, if not outright control, over broadcast and other media pose significant challenges to the opposition. In addition, the government has formed a constitutional commission to review ideas for constitutional change to lessen the power of the president.

MEDIA ENVIRONMENT

¶13. (SBU) Georgian media at present reflect the polarized political environment in the country, largely divided into pro-government and pro-opposition operations. Nationwide Qpro-government and pro-opposition operations. Nationwide television channels remain the main source of information for most people. Television content is limited, resulting in a majority of the population that is poorly informed about a variety of issues and everyday concerns. There are no hard walls separating the editorial and management sides of media organizations. The media market is small, creating financial challenges. Journalists are low-paid and practice self-censorship.

RELATIONS WITH RUSSIA

¶13. (SBU) While official relations between Russia and Georgia remain contentious, the two governments reached a preliminary agreement in December to reopen a border crossing for transit traffic to Armenia and limited access for Georgians, and the government has indicated that it is willing to sign a protocol as early as March. Georgian Airways ran a few charter flights to Moscow and St. Petersburg in January -- the first direct commercial flights since a brief period in 2008 -- and is negotiating for permission for more regular

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flights. The Russian embargo remains in place against Georgian products, though Russian goods are readily available in Georgia.

A TOUGH NEIGHBORHOOD

¶14. (C) Georgia is concerned by a significant increase in

military supplies from Russia to Armenia planned for 2010 primarily via overflights between Russia and Armenia. Although Georgia has continued to allow the flights to maintain a good relationship with Armenia, it does not believe Armenia has the capacity to use these shipments itself and fears that such armaments as large-caliber ammunition for aircraft could be intended for Russian forces in Armenia, instead of the Armenian military. Not only could such shipments disrupt the balance in the Nagorno-Karabakh conflict, but they could potentially be used to squeeze Georgia from the south as well.

¶15. (S) Georgia is also trying to manage its relationship with Iran. Georgia agrees with many of our concerns about Iran's policies, and has been willing to raise those concerns directly with the Iranians. Georgia still faces lingering anger from Tehran for extraditing an Iranian arms smuggler to the United States several years ago. At the same time, it cannot afford to alienate a powerful regional neighbor and a potential major commercial partner -- especially as it seeks to prevent any further recognitions of the breakaway regions. Although the government has assured us that a proposed hydro project does not involve Iranian banks, we continue to monitor the deal.
BASS